Supreme Court of the United States

OCTOBER TERM, 1942

No.

UNITED SHIPYARDS, INC.,

Petitioner,

—against—

JANE M. HOEY, as Executrix of the Estate of James J. Hoey, Deceased,

Respondent.

BRIEF IN SUPPORT OF PETITION

Opinions Below.

The opinion of the United States District Court for the Southern District of New York is not reported but may be found on pages 11 to 13 of the Record.

The opinion of the United States Circuit Court of Appeals is reported in 131 Fed. 2nd, 525, and appears in the Record on pages 33 to 38 inclusive.

Jurisdiction.

The jurisdiction of this Court to issue a writ of certiorari is predicated upon Title 28 of the United States Code Annotated, Section 347.

The reasons relied on for the allowance of the writ are that the United States Circuit Court of Appeals for the Second Circuit decided questions of general importance,

and questions of substance relating to the construction of a statute of the United States, namely, a tax law pertaining to capital stock tax, which questions have not been, but should be, decided by this Court. The other reasons relied on are set forth in the petition to which this brief is annexed at pages 5 to 9.

Statement of the Case.

The statement of the case is set forth in the petition for writ herein.

Specifications of Error.

First: The United States Circuit Court of Appeals for the Second Circuit erred in deciding that the status of a debtor in possession under Section 77B of the Bankruptcy Act for capital stock tax purposes for the capital stock tax year 1936 is different from the status of a corporation in reorganization under Section 77B of the Bankruptcy Act for the year 1936 where the Court in its discretion appoints trustees other than the debtor in possession. Under the Regulations, there is no capital stock tax liability where a trustee is appointed, therefore there is none where the debtor is left in possession.

Second: The decision of the United States Circuit Court of Appeals misinterprets the meaning and intention of the applicable provisions of Section 77B of the Bankruptcy Act and the tax law and regulations with respect to capital stock tax for the year 1936 in that no capital stock tax can properly be assessed against any debtor in a 77B proceeding. In a proceeding under Section 77B of the Bankruptcy Act, the bankruptcy court is administering a trust fund for the

benefit of all concerned and there is no capital stock or stockholders as such. There is a complete ouster of corporate management and control.

Third: The decision of the United States Circuit Court of Appeals in this case is in conflict with the principles enunciated in the decision of this Court in *Case* v. *Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106.

Fourth: The decision of the United States Circuit Court of Appeals in this case is in conflict with the opinion of the District Court in *Colorado Fuel & Iron Corp.* v. *Nicholas*, 28 Fed. Supp. 448 (affirmed 112 Fed. (2d) 858). (Tenth Circuit.)

Fifth: The decision of the United States Circuit Court of Appeals in this case is in conflict with other decisions in the Second Circuit pertaining to the status of a debtor in possession under the National Bankruptcy Act, particularly the decisions in *In re*: *Walker*, 93 Fed. (2d) 281; *In re*: *Martin Custom-Made Tires*, 108 Fed. (2d) 172; *In re*: *City of New York* v. *Rassner*, 127 Fed. (2d) 703.

Statutes and Regulations Involved.

The statutes and regulations involved, with pertinent excerpts therefrom, are as follows:

Section 105 of the Revenue Act of 1935 (49 Stat. 1017), Capital Stock Tax:

> "(a) For each year ending June 30, beginning with the year ending June 30, 1936, there is hereby imposed upon every domestic corporation with respect to carrying on or doing business for any part of such year an excise tax of $1.40 for each $1,000 of the adjusted declared value of its capital stock."

Section 401 of the Revenue Act of 1936 (49 Stat. 1733), Capital Stock Tax:

> "(a) Section 105 of the Revenue Act of 1935 is amended by striking out '$1.40' wherever appearing therein and inserting in lieu thereof '$1'."

Section 77B of the Bankruptcy Act (11 U. S. C. A., Sec. 207; 48 Stat. 912):

> "(a) * * * If the petition or answer is so approved, an order of adjudication in bankruptcy shall not be entered and the court in which such order approving the petition or answer is entered shall, during the pendency of the proceedings under this section, have exclusive jurisdiction of the debtor and its property wherever located for the purposes of this section, and shall have and may exercise all the powers, not inconsistent with this section, which a Federal court would have had it appointed a receiver in equity of the property of the debtor by reason of its inability to pay its debts as they mature. * * *
>
> * * * * * *
>
> "(c) (11) * * * In case a trustee is not appointed, the debtor shall continue in the possession of its property, and, if authorized by the judge, shall operate the business thereof during such period, fixed or indefinite, as the judge may from time to time prescribe, and shall have all the title to and shall exercise, consistently with the provisions of this section, all the powers of a trustee appointed pursuant to this section, subject at all times to the control of the judge, and to such limitations, restrictions, terms, and conditions as the judge may from time to time impose and prescribe. While the debtor is in possession (a) its officers shall

be entitled to receive only such reasonable compensation as the judge shall from time to time approve, and (b) no person shall be elected or appointed to any office, to fill a vacancy or otherwise, without the prior approval of the judge.

* * * * *

"(e) (1) A plan of reorganization shall not be confirmed until it has been accepted in writing, whether before or after the filing of the petition or answer under this section, and such acceptance shall have been filed in the proceeding by or on behalf of creditors holding two-thirds in amount of the claims of each class whose claims have been allowed and would be affected by the plan and by or on behalf of stockholders of the debtor holding a majority of the stock of each class: PROVIDED, HOWEVER, That such acceptance shall not be requisite to the confirmation of the plan by any creditor or class of creditors (a) whose claims are not affected by the plan, or (b) if the plan makes provision for the payment of their claims in cash in full, or (c) if provision is made in the plan for the protection of the interests, claims, or liens of such creditor or class of creditors in the manner provided in subdivision (b), clause (5), of this section: AND PROVIDED FURTHER, That such acceptance shall not be requisite to the confirmation of the plan by any stockholder or class of stockholders (1) if the judge shall have determined either that the debtor is insolvent, or that the interests of such stockholder or stockholders will not be affected by the plan, or (2) if provision is made in the plan for the protection of the interests of such stockholder or class of stockholders in the manner provided in subdivision (b), clause (4), of this section. * * *

"(f) (7) * * * The provisions of sections 901, 902, and 921 (b) (1) of Title 26 and the provisions of sections 724 and 725 of the Revenue Act of 1932, shall not apply to the issuance, transfers, or exchanges of securities or making or delivery of conveyances to make effective any plan of reorganization confirmed under the provisions of this section. * * *

"(h) Upon final confirmation of the plan, the debtor and other corporation or corporations organized or to be organized for the purpose of carrying out the plan, shall have full power and authority to, and shall put into effect and carry out the plan and the orders of the judge relative thereto, under and subject to the supervision and control of the judge, and the property dealt with by the plan, when transferred and conveyed by the trustee or trustees to the debtor or the other corporation or corporations provided for by the plan, or, if no trustee has been appointed, when retained by the debtor pursuant to the plan or transferred by it to the other corporation or corporations provided for by the plan, shall be free and clear of all claims of the debtor, its stockholders and creditors, except such as may consistently with the provisions of the plan be reserved in the order confirming the plan or directing such transfer and conveyance or retention, and the court may direct the trustee or trustees, or if there be no trustee, the debtor and any mortgagee, the trustee of any obligation of the debtor, and all other proper and necessary parties, to make any such transfer or conveyance, and may direct the debtor to join in any such transfer or conveyance made by the trustee or trustees. Upon the termination of the proceedings a final decree shall be entered discharging the trustee or trustees, if any, making such provisions as may be

equitable, by way of injunction or otherwise, and closing the case. Such final decree shall discharge the debtor from its debts and liabilities, and shall terminate and end all rights and interests of its stockholders, except as provided in the plan or as may be reserved as aforesaid. * * * "

The only Regulations involved are Articles 35 and 42 of Treasury Regulations 64 (1936 Edition), which provide as follows:

"ART. 35. Return by custodian—* * * If, at the close of the taxable year, all of the property of a corporation is in the custody of and being administered by a receiver or a trustee in bankruptcy, or is in the custody of a Federal or State officer pending the appointment of a receiver or trustee in bankruptcy, there shall be attached to the return a statement showing the date on which the property was placed in the custody of such officer and whether his custody has been continuous since that date. However, for any taxable year subsequent to the first, the adjusted declared value must be computed by starting with the original declared value as a base and making the definite adjustments required by the statute. Therefore, if at the time a return is required to be filed for such subsequent taxable year all of the property of a corporation is in the custody of and being administered by such official, he should prepare and file the return showing the required statutory adjustments from the records in his possession. If, during any entire year ending June 30, all of the property of a corporation is in the hands of such public official, the corporation is not subject to the tax for such year, but in order that its exempt status may be made known to the Commissioner such custodian shall file with the

collector of internal revenue an information return on Form 707, attaching thereto an affidavit showing the date on which the property came into his custody and the fact that his custody was continuous throughout such entire year.

ART. 42. Doing business— The term 'business' is very comprehensive and embraces whatever occupies the time, attention, or labor of men for profit. Accordingly, regardless of the nature of its activities, any corporation organized for profit and carrying out the purpose of its organization is doing business within the meaning of the Act. Similarly, even if not organized for profit, any corporation which nevertheless engages in activities ordinarily carried on for profit is also doing business. It is immaterial whether the activities result in a profit or a loss, whether the corporation has been successful in its enterprise, or that because of unfavorable business conditions, no operations are carried on for a particular period. No particular amount of business need be done, nor is it necessary that the business be continuous throughout the taxable year.

The case is exceptional in which the activities of a corporation organized for profit do not amount to doing business within the meaning of the Act. Such a case is generally limited to one in which the corporation is not pursuing the ends for which organized, i.e., profit."

Summary of Argument.

(1) There is no distinction for capital stock tax liability purposes between a debtor in possession and a trustee as such under Section 77B of the Bankruptcy Act.

(2) Neither a debtor in possession nor a debtor in a proceeding in which trustees are appointed in reorganization under the Bankruptcy Act is liable for capital stock tax.

(3) Whether there is a debtor in possession or a trustee appointed by the Court administering the assets of a debtor in reorganization, the Court administers the assets as a trust fund for the benefit of creditors and there is a complete ouster of corporate management and control.

(4) There is no capital stock as such of a debtor, i.e. either a debtor in possession or a debtor for whom trustees have been appointed in a reorganization proceeding.

(5) The decision of the United States Circuit Court of Appeals is in conflict with the principles set forth in the opinion of this Court in *Case* v. *Los Angeles Lumber Products Co. Ltd.,* 308 U. S. 106, and with the decisions of other Federal Courts, including the decision of the District Court of the District of Colorado in *Colorado Fuel & Iron Co.* v. *Nicholas,* 28 F. Supp. 448, affd. 112 F. (2d) 858; the decisions of the United States Circuit Court of Appeals, Second Circuit, in the cases of *In re*: *Walker,* 93 F. (2d) 281; *In re*: *Martin Custom-Made Tires Corp.,* 108 F. (2d) 172 and *City of New York* v. *Rassner,* 127 F. (2d) 703.

ARGUMENT

POINT I.

The alleged distinction for capital stock tax liability purposes between a debtor in possession pursuant to Section 77B of the Bankruptcy Act and a debtor in a proceeding in which the Bankruptcy Court appoints trustees is non-existent.

The Commissioner in Regulations 64 Article 35 states that if during any entire year ending June 30th all of the property of a corporation is in the hands of such public official, the corporation is not subject to the tax for such year. "Such public official" is defined in said Regulation as " * * * receiver or a trustee in bankruptcy * * * " or " * * * a Federal or State officer pending the appointment of a receiver or trustee in bankruptcy".

Petitioner asserts that there is no distinction for capital stock tax purposes between a debtor in possession and the trustees of a debtor in a bankruptcy reorganization proceeding. In the last analysis, we understand a debtor in possession arrangement to be that a District Court Judge in charge of the reorganization proceeding has designated the officers of a debtor to take possession of the property and estate of the debtor while the Court retains custody and control. The officers of the debtor, as trustees, are responsible to the Court and not to the stockholders. In the case where the Court appoints trustees as such for a debtor in a reorganization proceeding, the corporation is not subject to capital stock tax liability in view of the provisions of Regulations 64 Article 35 cited *supra*. In both instances, whether the debtor is in possession or whether trustees as

such are appointed, the assets of the corporation are controlled and supervised by the District Court under a trust relationship whereby the assets constitute the corpus of the trust being administered for the benefit of creditors.

The foregoing is in accordance with the opinion of this Court in *Case* v. *Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106, where at page 127 the Court states:

> "When that jurisdiction attached, the court rather than the stockholders was in control with all of the powers and duties which that entailed under Section 77B."

and at page 130 states:

> " * * * As a result of the filing of the petition in this case, the court, not the stockholders, acquired exclusive dominion and control over the estate."

In the *Los Angeles Lumber Products Co. Ltd.* case, there was a debtor in possession, and the question presented therein was whether or not the Plan was fair and equitable, particularly to objecting stockholders, who asserted a right to be considered in and to be recognized in the proposed Plan of Reorganization. The Court pointed out that stockholders and other junior interests may be excluded from any Plan of Reorganization in the event the debtor is insolvent. Accordingly, the stockholders of a corporation in reorganization have been ousted from control of the administration of corporate affairs which is vested in the Court.

In the instant case, petitioner was a debtor, in possession by order of the District Judge in a 77B proceeding, and all the property of the debtor was in control of the Court. The order continuing the debtor in possession contained the following provision (R. 20):

> "(1) To have and to exercise consistently with the provisions of said Section 77B, all the powers of trustees appointed pursuant to Sections 44 and 77B of the Bankruptcy Act and the same powers as those exercised by a receiver in equity to the extent consistent with said Section 77B."

In the opinion of the Circuit Court of Appeals, there is considerable discussion of the question of what constitutes "doing business". We submit that the test for capital stock tax purposes under the facts presented herein is "who" was doing the business and not whether any business was being done. It is conceded in the Regulations cited *supra* and which were based upon the decision of *United States* v. *Whitridge,* 231 U. S. 144, decided in 1913, that if a trustee were appointed, there would be no capital stock tax liability upon the debtor as such, in spite of the fact that there is no question that business was being done during the proceedings under the direction of the Court.

The United States Circuit Court of Appeals, Second Circuit, under a variety of circumstances reached a similar conclusion. For instance, *In re*: *Walker* (C. C. A. 2d, 1937), 93 F. (2d) 281 at page 283, the Court stated as follows in discussing the pertinent provisions of the Bankruptcy Act:

> " * * * the purpose of subdivision (c) (11), 11 U. S. C. A., §207 (c) (11), is certainly that the debtor shall be in fact a trustee, if the judge thinks best; otherwise an independent trustee is inevitable, since the court must in some fashion control the property."

To the same effect, in different circumstances, the same Court in *In re*: *Martin Custom-Made Tires Corp.* (C. C. A. 2d, 1939), 108 F. (2d) 172, at page 173 stated:

> "The attempted distinction between the powers of a debtor in possession and the rights of a trustee in bankruptcy is unreal. A debtor in possession holds its powers in trust for the benefit of the creditors."

Again in *City of New York* v. *Rassner,* 127 F. (2d) 703 (C. C. A. 2d, April 1942) the Court stated at page 705:

> "When the petition was filed and the debtor continued operation it acted as an officer of the Bankruptcy Court."

In each of the cases cited above, there was a debtor in possession, and a careful analysis of the facts in each of those cases indicates that the result in each case would have been different if the Court had not found that the debtor was in fact a trustee and that the attempted distinction between the powers of a debtor in possession and the rights of a trustee in bankruptcy is unreal. Petitioner contends that the decisions in each of the cases cited are sound and consistent with the provisions of Section 77B of the Bankruptcy Act.

In view of the foregoing, we submit that petitioner was not subject to capital stock tax liability for the year 1936 when at all times during said capital stock tax year ending June 30th, petitioner was in reorganization under Section 77B of the Bankruptcy Act, and under the custody and control of the District Court.

POINT II.

Neither a debtor in possession nor a debtor in a proceeding in which trustees are appointed pursuant to Section 77B of the Bankruptcy Act is liable for capital stock tax because in both instances the Court is administering a trust fund for the benefit of all persons interested in the trust estate and because there is no "capital stock" as such of a debtor.

The decision of the United States Circuit Court of Appeals is erroneous because it is based upon the assumption that a corporation in reorganization is a domestic corporation carrying on its business as though the reorganization proceeding had not intervened. Such an assumption is in conflict with the "trust fund" principle set forth in the decision in *Case* v. *Los Angeles Lumber Products Co. Ltd.,* 308 U. S. 106, cited and analyzed under Point I hereof. Under the "trust fund" principle, the Court has exclusive control and supervision of the trustees of the assets whether such be the debtor in possession or whether such trustees be other persons designated by the Court.

Under the trust fund principle as applied to a debtor in possession, the assets of the debtor under the control and supervision of the Court are not subject to capital stock tax under the decision in *U. S.* v. *Whitridge,* 231 U. S. 144 and under the Regulations issued by the Commissioner, i.e. Regulations 64 Article 35 cited *supra.*

There is good reason for not asserting a capital stock tax against a debtor in reorganization because the status of such a debtor is entirely different from the status of the corporation prior to the filing of the petition. During reorganization, creditors of a debtor are restrained from asserting their

rights to the end that the assets may be made available to all creditors pro rata in accordance with their rights. Prior to the filing of a petition in reorganization, a mortgagee may foreclose a mortgage, whereas such foreclosure action is either prohibited or stayed during the reorganization period, and such claims are disposed of in the Reorganization Plan. Because of the uncertainty of the ultimate disposition of claims and of assets during a reorganization and because the assets are under the control and administrative supervision of the District Court, the Commissioner of Internal Revenue has consistently taken the position that where assets of a debtor are in the control and custody of a Federal or State officer, that such assets are not subject to capital stock tax. (Article 35, Regulations 64.)

A capital stock tax is a license tax imposed upon a domestic corporation for the right to do business (Section 105(a) Revenue Act of 1935). The term "domestic corporation" as used in the statute cited *supra,* we submit, means an ordinary domestic corporation and not a debtor corporation in reorganization.

The decision of the Circuit Court of Appeals is erroneous because it holds that a debtor in possession under Section 77B of the Bankruptcy Act is liable for capital stock tax for the capital stock tax year 1936. Section 105(a) of the Revenue Act of 1935 as amended cited *supra* imposes a tax upon

(a) domestic corporation

(b) with respect to carrying on or doing business of $1.00 for each $1,000 of the adjusted declared value of its capital stock.

Petitioner was not a domestic corporation carrying on business with any capital stock during the capital stock tax

year 1936. We understand the "capital stock" of a corporation to be the property of the corporation contributed by its stockholders or otherwise obtained by it. Capital stock of a corporation does not mean share stock. *Williams* v. *Western Union Telegraph Company,* 93 N. Y. 162, 188; *Equitable Life Assurance Society* v. *Union Pacific RR Co.,* 162 App. Div. 81, affd. 212 N. Y. 360. When a corporation files a petition in reorganization and the Court takes jurisdiction, what was formerly the capital stock of such a corporation, becomes the trust res or the trust fund administered under the supervision and control of the District Court in the reorganization proceeding, and there is a complete ouster of corporate management and control.

In view of the foregoing, we submit that petitioner is not liable for capital stock tax for the year 1936 because it was not carrying on business as a domestic corporation and there was no capital stock, but a trust res administered and controlled by the Court.

POINT III.

The decision of the United States Circuit Court of Appeals is in conflict with the principles enunciated in the opinion of this Court in *Case* v. *Los Angeles Lumber Products Co. Ltd.*, 308 U. S. 106, and with decisions of various other Federal Courts.

The United States Circuit Court of Appeals, Second Circuit, in the opinion in this case stated (R. 33, 37):

> " * * * A debtor company in possession is not a receiver or trustee. * * * For the corporation debtor is still carrying on or doing business, although the manner in which it can operate is restricted by trustee obliga-

> tions imposed by the Bankruptcy Act. * * * The plain truth is that it was still doing its business, but subject to limitations, under the Bankruptcy Act, restricting the purposes for which, and the manner in which, it could conduct that business."

This statement is in direct conflict with the decision of this Court in the case of *Case* v. *Los Angeles Lumber Products Co. Ltd.,* 308 U. S. 106. We quote from the opinion of this Court in that case as follows:

> "The right to remain in unmolested dominion and control over the property was necessarily waived or abandoned on invoking the jurisdiction of the Federal courts in these proceedings. When that jurisdiction attached the court rather than the stockholders was in control with all of the powers and duties which that entailed under §77B" (p. 127).
>
> * * * * *
>
> "* * * As a result of the filing of the petition in this case, the court, not the stockholders, acquired exclusive dominion and control over the estate" (p. 130).

As we understand the decision in the *Los Angeles Lumber Products Co. Ltd.* case, there can be no distinction between a debtor in possession and a trustee in a reorganization proceeding in so far as the control and custody of the Court is concerned and in so far as the trust principle of the administration of the assets in the control of the court is concerned.

The decision of the United States Circuit Court of Appeals in this case is in conflict with the opinion of the District Court in the case of *Colorado Fuel & Iron Co.* v. *Nicholas,* 28 F. Supp. 448 (affd. 112 F. (2d) 858 (Tenth Cir-

cuit)). According to the opinion in the District Court, the same question was presented in that case as was urged by the Government in this case, namely, the asserted distinction for capital stock tax purposes between a debtor in possession and a trustee in a reorganization proceeding. With respect to this contention, the District Judge stated at page 450:

> "I doubt if the distinction is a good one, but be that as it may, he supports the view that where the court is operating the property and not the corporation, the latter is not liable for the tax."

The decision of the United States Circuit Court of Appeals in this case as set forth in Point I of this brief is in direct conflict with the principles of that Court as set forth in the decisions *In re: Walker*, 93 F. (2d) 281; *In re: Martin Custom-Made Tires Corp.*, 108 F. (2d) 172; and *City of New York* v. *Rassner*, 127 F. (2d) 703. In each of the foregoing decisions the Circuit Court of Appeals for the Second Circuit under varying sets of facts held in substance that under 11 U. S. C. A. 207 (c) (11) a debtor in possession is in fact a trustee, and there is no distinction except in name between a debtor in possession and a trustee for a debtor in a reorganization proceeding. The Circuit Court of Appeals of the Second Circuit could only have decided each of the foregoing three cases as it did if there was no distinction between a debtor in possession and a trustee in a reorganization proceeding.

CONCLUSION.

Therefore, the questions herein are questions of general importance and questions of substance relating to the construction of a tax statute of the United States and the application should be granted.

Respectfully submitted,

JOHN F. CONDON, JR.,
Solicitor for Petitioner,
United Shipyards, Inc.

HUBERT E. ROGERS,
JACK M. EVANS,
Of Counsel.